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ABSTRACT

Prospects for the enlargement of the European Union (EU) became imminent when the EU Commission agreed in 1997 to open formal negotiations with five of the Central and Eastern European countries: (1) the Czech Republic; (2) Hungary; (3) Poland; (4) Slovenia; and (5) Estonia. This research project discusses macroeconomic policy challenges that Hungary and Poland face as they work toward membership in the European Union. The project examines the macroeconomic policies that these two countries have implemented in recent years, as well as those that they are currently pursuing to meet the necessary targets and objectives. The project contains four parts: (1) "Introduction"; (2) "Hungary's Road to the EU" (recent economic trends; monetary policy management; fiscal policy management; macroeconomic policy challenges for the near term); (3) "Poland's Road to the EU" (recent economic trends; monetary policy management; fiscal policy management; macroeconomic policy challenges for the near term); and (4) "Conclusion." (Contains 13 references.) (BT)

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The Road to the European Union: Macroeconomic Policy Challenges for Hungary and Poland

Teresita R. Ramirez, Ph.D.

I. Introduction

The prospects for the enlargement of the European Union (EU) became imminent when the European Union (EU) Commission agreed in 1997 to open formal negotiations with five of the Central and Eastern European countries – the Czech Republic, Hungary, Poland, Slovenia, and Estonia. According to the Commission, these five countries had made the most progress toward meeting the requirements for accession into the EU. This paper will focus on the efforts made by Hungary and Poland to meet the challenges of accession. In particular, it will examine the macroeconomic policies that these two countries have implemented in recent years as well as those that they are currently pursuing to meet their targets and objectives.

The EU membership process requires applicants to meet a broad set of political, economic, and institutional criteria as set forth in the EU's Copenhagen criteria in 1993, namely: (a) the existence of stable institutions that guarantee democracy, the rule of law, human rights, and the protection of minorities; (b) the existence of a functioning market economy capable of competing within the EU market; and (c) the ability to implement the EU membership obligations which include the achievement of monetary and other economic goals (OECDa, 2002). In contrast to the Maastrict criteria for European Monetary Union (EMU) membership, the EU accession process does not set very specific quantified requirements for monetary and fiscal policies. Nonetheless, it is inherent in the process that a candidate country's readiness becomes more evident if it has a sustainable set of sound macroeconomic policies.

Within the context of EU accession, the main goal of macroeconomic policy is the creation of a policy framework that will achieve real and nominal convergence between the candidate's economy and the EU members' economies. The primary challenges for monetary policy are the relative price adjustments to maintain an equilibrium inflation differential between the applicant and the EU members. The challenge for fiscal policy is to ensure the financing of the requirements for economic growth while reducing the overall expenditure and deficit levels. To a large extent, Hungary and Poland have tried to address these challenges in recent years, but the road that lies ahead for each country differs.

II. Hungary's road to the EU

A. Recent macroeconomic trends

Hungary's economic growth in the last four years has been remarkable. Its gross domestic product (GDP) grew at an average annual rate of 4.5 percent from 1998 to 2001, and the unemployment rate fell from 8.9 percent in 1997 to 5.8 percent in 2001 (OECDa, 2002). Inflation as measured by the consumer price index declined during the same period from 18 percent to 9 percent despite the rapid growth in output. Its current account deficit as a percentage of GDP likewise declined from 7 percent to 6 percent. These indicators of overall economic performance reflect the results of continued efforts at economic liberalization during the process of transition to a market economy.

Slowdown in 2001

As a result of a general weakening of EU economies in 2001, the demand for Hungarian exports declined and contributed to a slowdown of GDP growth from 5.2 percent in 2000 to 3.8 percent 2001. This growth, however, was still considerably higher than most countries in the region (IMFa, 2002). Manufacturing activity, particularly the information technology sector, was most affected by the deteriorating external conditions.

Competitiveness indicators such as labor productivity and relative labor costs in manufacturing also exhibited a slowdown in 2001. The new exchange rate regime introduced in May 2001 which ended the narrow-band crawling peg regime contributed to the decline in the competitiveness of Hungary's exports as the forint appreciated strongly in the second half of 2001 (OECDa, 2002).

While the total unemployment rate has fallen in recent years, the labor force participation rate also declined in 2001. Real wage per worker grew at a slower pace than real GDP per worker.

B. Monetary policy management

The adoption in the mid-1990s of a crawling-peg exchange rate regime with a narrow band was successful in reducing the average inflation rate from 28 percent in 1995 to 10 percent in 1999, while at the same time promoting export growth (OECDa, 2002). However, in mid-2000, the inflation rate somehow "got stuck" at around 10% as a result of the rising international prices of food and energy supplies. The disinflation process became more difficult as the narrow exchange rate band did not allow enough room for monetary policy maneuvering.

The monetary policy framework changed in May 2001 when the narrow-band crawling-peg regime was abandoned and replaced by a wider band, which allowed for a more comprehensive inflation-targeting policy to be pursued.

Inflation-targeting

In July 2001, the Hungarian Parliament adopted a new Central Bank Act which gave greater independence to the National Bank of Hungary (NBH), and made price stability its primary objective. Within this new policy framework, the NBH adopted an inflation-targeting strategy to conduct monetary policy.

The inflation forecast of the NBH, which is publicly announced, serves as the intermediate inflation target. Unlike the practice in the previous monetary regime where the government determines its own projected inflation rate separately from that of the Central Bank, the new targeting framework allows for the government and the Central Bank to agree on the inflation target before it is announced. The inflation scenarios of the Central Bank and the assumptions and risks pertinent to these scenarios are made explicit to the public (OECDa, 2002). In the event that unexpected external shocks disturb these scenarios, monetary policy will respond if the nature of the shock is permanent.

In line with Hungary's longer term projection of joining the EMU, the medium-term path of disinflation set by the Central Bank reflects the objective of attaining the Maastrict criteria of reducing the inflation rate to 2-2½ percent. Hungary's integration into the euro zone is a goal that seems to pull together the economic authorities' stronger commitment to achieve the path of disinflation and create an environment of price stability.

Exchange rate appreciation

The exchange rate is a powerful transmission of monetary policy in a small open economy such as Hungary. Thus, the Central Bank monitors closely fluctuations in exchange rates and the passthrough effects of currency appreciations or depreciations. After the adoption of a wider-band exchange rate regime, the forint appreciated with respect to the euro in both nominal and real terms. To a large extent, this was due to increases in capital inflows. However, despite the continued appreciation of the forint, it has never reached the upper limit of the new widened band, and so the NBH has not engaged in any corrective intervention in the foreign exchange market.

The net result of the appreciation of the real exchange rate and the increase in short-term interest rates was a contractionary monetary environment in 2001. With inflationary expectations falling faster than nominal interest rates, real short-term interest rates increased modestly and the forint strengthened against the euro by around 10 basis points since the

band widening. If an international economic recovery happens in 2003, this tight monetary condition may have to continue to counter the inflationary pressures that may ensue.

C. Fiscal policy management

The budget deficit

The government exhibited remarkable progress in its fiscal management in recent years, as shown by a significant reduction in the budget deficit – from 8.3 percent of GDP in 1998 to 3.0 percent in 2000. However, the ratio rose to 5.2 percent in 2001 as there was a loosening of fiscal policy in the last phase of the electoral cycle (OECDa, 2002). Public expenditure increased on government wages, housing, and small and medium enterprises. Families with children were given substantial tax breaks. For 2002, the loose budget is expected to continue as the government increases public sector wages by 19 percent. Clearly, if the government expects accession in 2004 to go on as planned, a tightening of fiscal policy may have to be implemented in the next two years.

Debt management

Hungary is a moderately indebted country with gross foreign debt estimated at $33.5 billion at the end of 2001 (IMFa, 2002). As a ratio pf GDP, gross public debt has been declining in the past three years, from 63.4 in 1999 to 55.5 in 2001. The appreciation of the forint has reduced the amount of debt expressed in forints, which constitutes two-thirds of public debt (OECDa, 2002). Hungary is also one of a few countries who has never defaulted nor rescheduled its foreign debt. The future of the debt situation may of course change depending on the success of the disinflation process and the implementation of the structural budget reforms.

Structural budget reforms

A recent study by the OECD (2002) of Hungary's public expenditure system reveals that relative to other European countries with the same income per capita, Hungary continues to be a high tax and a high spending country. Large spending items include expenditures on public services (7.3 percent of GDP, one of the highest in Europe), and subsidies to production and consumption (5.4 percent of GDP). The composition of expenditures in Hungary is comparable to that of the high-spending countries of Western Europe.

The OECD study examined in detail the structural features of Hungary's public spending system, with the end in view of recommending reforms to

strengthen the management of government spending in the country. The recommendations include:

- the reduction in the share of total primary spending in GDP to 41.5 percent by 2004 (ratio was 63.4 percent in 1994 and 48.3 percent in 2000);
- consolidation of all quasi-fiscal activities in the budget;
- statement of government policy at the beginning of each legislature as a strategic policy framework, and annual policy statement outlining priorities of the budget;
- development of accrual-based budget monitoring in addition to cash monitoring; and
- development of the functional audit capabilities of the State Audit Office.

D. Macroeconomic policy challenges for the near term

The longer-term objective of joining the EMU in 2006-2007 has been the overriding influence in the recent macroeconomic policies of the government. The abandonment of the crawling-peg regime, the widening of the exchange rate band, and the removal of exchange rate restrictions allow for the creation of the liberalized markets that are necessary to join the EMU. The opening of the economy to foreign investment and the creation of a business-friendly environment have contributed greatly to the strong growth of Hungary's economy.

The primary challenge now for economic authorities is the reduction in the income differential and standards of living between Hungary and the euro area throughout the years preceding accession into the EMU. With the adoption of an inflation-targeting strategy, the monetary authorities appear to be better poised to face the challenge of reducing the inflation differential between Hungary and the euro area. However, the effects of an international recovery, increases in productivity, and inflationary expectations may pose additional challenges for monetary policy in the near future.

The goal of price stabilization will require fiscal discipline. It is never an easy task for government to undertake reforms in spending and taxation. Perhaps, as suggested by OECD, it may be crucial that structural changes take place first before decisions on budgetary cuts are even made. The fragmentation in the provision of public services, overstaffing, and technical inefficiency are the challenges that may have to be addressed more urgently in the public finance arena.

III. Poland's road to the EU

A. Recent macroeconomic trends

Poland exhibited remarkable economic growth during the 1990s, with an annual average real GDP growth rate of 4.9 percent from 1992 to 2000. The inflation rate declined steadily throughout these years until 1998, when inflationary pressures mounted mainly because of rising food prices and fuel imports. The structural changes in the economy brought about rising unemployment rates, which reached a peak of 16.4 percent in 1993, declined steadily to 10.4% in 1998, and then continued to rise again thereafter (OECDb, 2002).

Slowdown of growth in 2001

The growth of real GDP in Poland fell considerably from 4.0 percent in 2000 to 1.0 percent in 2001 (Table 1). The first quarter of 2002 showed the same downward trend. The decline in domestic aggregate demand which started in the third quarter of 2000 has been mostly due to the marked reduction in private domestic investment (Table 1). A primary reason for the investment activity slowdown was the contractionary monetary policy in 2000. The inflationary pressures brought about by the high growth periods preceding 2001 led to high interest rates, which discouraged private domestic investment. The growth of export activity likewise slowed down due to the weakening economies of its European trading partners.

Table 1
Gross domestic product
(annual % change)

	1999	2000	2001	2002, Q1
GDP	**4.1 %**	**4.0 %**	**1.0 %**	**0.5 %**
Household consumption spending	5.2	2.7	2.1	3.5
Government spending	1.3	1.5	0.6	--
Gross domestic capital formation	6.8	2.7	- 9.8	- 13.3
Exports of goods & services	- 2.6	23.2	10.8	--
Imports of goods and services	1.0	15.6	- 0.1	--

Source: *OECD, Central Statistical Office and National Bank of Poland*

High unemployment

The marked slowdown in economic growth was accompanied by a record unemployment rate of 19 percent in 2001, and 20.3 percent in the first quarter of 2002. Poland's rate of unemployment is the highest in the OECD area and almost three times the region's average (OECDb, 2002). It is estimated that

almost half of the working-age population in Poland is without work, and that the problem of unemployment is basically structural in nature.

Low inflation

The disinflationary effects of a decline in domestic aggregate demand showed in the rates of inflation falling from a peak of 11.6 percent in July 2000 to 1.9 percent in 2002.

B. Monetary policy management

Inflation-targeting

The National Bank of Poland adopted an inflation-targeting policy in 1998, which set out to reduce the inflation rate to 4 percent by the end of 2003. Poland's experience with inflation-targeting has been mixed, in the sense of its targets being missed since 1998. The rate was undershot in 1998, overshot in 1999 and 2000, and again, was way below target in 2001. Inflation-targeting has not been easy for monetary authorities because of the many non-market forces that continue to affect the process of transition, and because regulated prices still constitute a significant share of the consumption basket (OECDb, 2002).

Exchange rate policies

In April, 2000, The NBP abandoned the crawling-peg regime that had been in existence since 1991, and adopted a floating exchange rate system. A new foreign exchange law in 1999 allowed for the removal of many restrictions on foreign exchange transactions for resident portfolio investments and investment in securities issued by OECD countries (U.S. Dept. of State, 2002). The liberalization of the foreign exchange market is in line with the government policy of allowing to zloty to find its equilibrium level as a preparatory step before it applies to join the EMU.

Interest rate policy

Short-term interest rates increased substantially in 1999 and 2000 following the rapid rise in inflation rates. Despite this rapid rise in price levels, real interest rates still remained high at about 9 percent until the fourth quarter of 2001 (OECDb, 2002). The rise in real interest rates was accompanied by an appreciation of the zloty against the euro. During most of 2000 and 2001, the real appreciation of the zloty indicates that monetary policy has been relatively tight despite more recent attempts by the NBP to cut interest rates.

C. Fiscal policy management

The rising budget deficit

The relative tightening of fiscal policy during the years 1999 to 2000 reflected in the decline of the government budget deficit from 3.2 percent of GDP in 1998, to 2.9 percent in 1999, and to 2.1 percent in 2000. However, with the slowdown in economic growth and low inflation rates in 2001, fiscal policy sharply eased and led to the budget deficit rising sharply again to 4.8 percent of GDP. The deficit jumped up partly because of lower tax revenues from indirect taxes and corporate income taxes, and because of smaller privatization revenues. Low tax compliance is likewise considered a major factor in the deterioration of government revenues. The more significant reason for the rise in the budget deficit was the increase in government transfer payments and subsidies. Central government spending on transfers and subsidies increased by almost 24 percent from 2000 to 2001 because the government had to cover for the non-payment of social security contributions by some state-owned enterprises.

Public debt management

The lower than expected receipts from the privatization of public enterprises and the rising budget deficit led to a larger public sector debt that was estimated to be about 41 percent of GDP 2000. This ratio is estimated to rise to 47 percent in 2002. About 40 percent of public debt is denominated in foreign currency. The government has adopted a strategy of managing this debt through a long-term restructuring program.

D. Macroeconomic policy challenges for the near term

The overall policy challenge for Poland's economic authorities appears to be that of finding the right balance or mix of monetary and fiscal policies to achieve their goals. In the past, there have been instances when these policies were pulling each other in opposite directions. The easing of fiscal policy in 2001 did not seem to work well with the relative tightening of monetary policy. Clearly, the task of policy-making and implementation has not been easy for Poland especially in the last two years.

Poland's relative success in slowing down inflation rates since the second half of 2000 may indicate that a slow easing of monetary policy may continue to be an option in the near future to help boost output growth and employment. On the other hand, there is a huge task of containing the rise in the fiscal deficit. Restraining spending when unemployment rates are soaring is a daunting task for any economy. Perhaps, a call for more efficient spending especially in the social services sector may be necessary. Transfer payments and subsidies are never easy to reduce, much less take away. But it is also

imperative that public assistance programs be designed such that the end goals are to alleviate poverty and reduce unemployment. A labor market where average and minimum wages are lower than the amount of government transfers signal the need for the correction of market imperfections.

While inflation does not appear to be an imminent problem for the economy in the near future, an easing of monetary policy may have to be guarded to prevent any unexpected or sudden surges in inflation rates.

The estimated public debt/GDP ratio of 47 percent is still below the Maastrict criteria of 60 percent; however, the government faces the challenge of ensuring that the ratio does not rise any further, if the ultimate goal is to join the EMU.

IV. Conclusion

Throughout the 1990s, Hungary and Poland have both proven to be resilient to the regional and global international economic upheavals that have affected their economies. Both countries survived the Russian crisis and the Asian crisis, and are relatively holding up well with the current slowdown of the economic growth in Western Europe. Pursuing generally sound economic policies throughout the decade, they have both transformed their economies at a faster rate than most transition economies in the region.

The two countries, however, face different economic challenges as they both look ahead to join the EU, and eventually the EMU. Hungary's primary challenge in macroeconomic policy is to reduce the inflation differential and the GDP per capita between the country and the euro region. The catching-up process requires improvements in factor productivity and in the labor force participation rate. Poland's primary challenges are to reduce the high unemployment rate and to pursue fiscal discipline—the reduction in the budget deficit to an average 2 percent of GDP achieved during most of the transition period. There appears to be a lot of room for improving the efficiency in the use of resources geared towards social services and welfare expenditures. The restructuring of the public assistance system that is geared towards providing incentives for paid-work appears to be a major public policy concern of the government because of its implications on the high unemployment rate. Clearly, the task of fiscal restraint is a formidable challenge for Poland at this time.

The road to the European Union is not smooth. Both countries, however, appear to be resolute in riding on sound macroeconomic policies to make the journey as least costly as possible. Undoubtedly, there will be a segment of each country's population who, for nationalistic, economic, or political reasons, probably feel that the road to the EU should not be taken at all. This may be especially true for Poland, where there seems to be more pessimism and

ambivalence towards the market and suspicion of the EU. One thing that is clear, however, is that the governments of both Hungary and Poland appear to be strongly committed to hurdle the obstacles that may hamper integration by 2004. They are convinced that, notwithstanding the painful short-term costs of preparing for accession, there is no better alternative for their countries if long-term economic progress is to be achieved.

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